

War is not a reason to raise interest rates

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Thumbnail text

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Title

Why war and oil prices are not a reason to raise interest rates

Description

The Bank of England meets on 19 March to decide on interest rates.

Many commentators now say rates cannot fall because war in the Middle East could push up oil and gas prices and increase inflation.

But that argument misunderstands what is actually causing inflation.

If prices are rising because of a global energy shock, raising interest rates will not reduce those prices. Instead, it will increase mortgage costs, reduce investment and push the UK economy closer to recession.

In this video, I explain why imported inflation from oil and gas prices requires a completely different response from the Bank of England.

Not all inflation is the same, and treating it as if it were is simply bad economics.

<https://www.youtube.com/watch?v=jn3aoRTJ5pg?si=T3736bhFU8L7yqkb>

This is the audio version:

https://www.podbean.com/player-v2/?i=xcfuc-1a6213d-pb&from=pb6admin&share=1&download=1&rtl=0&font=Arial&skin=f6f6f6&font-color=auto&logo_link=episode_page&btn-skin=c73a3a

This is the transcript:

We need to talk about war, oil prices, and interest rates because they are all intimately related at this moment, and that is, of course, a matter of concern to me because I believe that interest rates are too high in this country.

The Bank of England next meets to discuss interest rates on the 19th of March. Many commentators were expecting that interest rates would fall on that day. Now the same people are saying that interest rates cannot fall. Why? Because of the war in the Middle East. They say, in the face of oil and gas prices rising, we must see maintained interest rates or even that interest rates must rise to challenge the inflation that they claim is bound to follow from those increases in oil and gas prices. But there is a serious problem with that argument, and I want to discuss why it's wrong.

People are being told that higher energy prices will mean higher inflation, and I'm not arguing with that. I suspect that that is true. We do already face a risk of an increase in inflation of 0.3% or so a year. It may be worse than that. Household energy prices could increase by £500 a year as a result of what has already happened in the Middle East, and it may get worse. Therefore, it is argued that interest rates must stay high or even rise again, and the Bank of England is already murmuring about the fact that this might be needed to control inflation, but that logic only works in very specific circumstances.

The key question to ask is this: what is causing inflation right now? Is it too much spending in the UK economy, or is it an external price shock? Because those are completely different problems that both give rise to inflation, but which require totally different policy responses.

The reality is that at present we are facing oil and gas prices that are set on global markets increasing as a consequence of war. They're rising because of geopolitical stress. The UK does not control those prices. This is the simple, straightforward statement of fact which has to be taken into account when deciding on interest rate policies.

Inflation in oil and gas prices is imported inflation. Nothing that happens in the UK has given rise to that inflation risk. In that case, we have to decide what interest rates are actually designed to do.

Interest rate increases are designed to reduce domestic demand within the economy. They do that by making borrowing more expensive. They discourage investment, and they reduce consumer spending. The consequence is that interest rate rises are intended to cool an overheating economy.

But we haven't got an overheating economy. What we've actually got is enforced additional non-discretionary spending on oil, gas, and electricity. People simply cannot avoid these costs. They have to heat their homes. They have to fuel their cars. Businesses cannot stop using energy, and energy demand is largely non-optional.

So, higher interest rates do not reduce energy prices. What higher interest rates actually do is increase mortgage payments and push up rents, discourage business investment, and reduce spending in the rest of the economy, while leaving the energy price shock entirely untouched.

Despite this, the Bank of England's defence for increasing interest rates is that they must stop what they call 'The Second Round Effects'. They claim they worry about workers demanding higher wages, and pay rises chasing higher prices, and a wage-price spiral developing as a result, as a consequence of which inflation becomes embedded. But this assumes workers have significant bargaining power, and that assumption is deeply questionable. In reality, real wages have been weak for years. Trade union power is far lower than in the past, and many workers have little negotiating power at all. They're on contracts which deny them every chance to change their wage rate. Pay, as a result, has rarely kept in line with increasing prices already, so the wage-price spiral argument is totally exaggerated.

The real consequence if the bank raises interest rates because of oil prices is that households will become poorer. Mortgage holders will suffer higher costs. Businesses will impose delays in investment programmes, and that will reduce employment opportunities. Economic activity will slow as a consequence, and we will head for recession and all the while the price of oil will not change.

So what should we be recognising? When inflation is driven high by energy shocks, interest rates are the wrong instrument to use. They treat the symptoms but not the cause of this inflation. They shift the burden of risk onto households, and they risk pushing the economy towards recession. The real point we need to understand is something important: not all inflation is the same. Some inflation comes from overheating economies. In those cases, interest rate rises can, I stress, can work, although taxation would normally do the job better.

But some inflation of the sort we're now getting has come from external shocks, and this was also true, of course, in 2022. Using the same policy for both overheating economies and external shocks is simply bad economics.

So, when the Bank of England meets on the 19th of March, ask yourself, is the inflation

being driven by war and global energy prices, which should therefore result in UK mortgage holders and businesses being asked to pay the price, even though they did not create this situation? Or should the Bank of England be leaving interest rates where they are, or even reducing them to compensate for the higher costs that households are already paying as a consequence of increased oil prices, with those reduced interest rate costs then rebalancing the economy in a way that guarantees stability?

That is the question the Bank of England should be asking.

That is not the question it will be asking.

It will only be asking about inflation, and it will only be asking about the question of whether or not to raise rates, because that's what they always do when they see an inflation risk, irrespective of the consequences.

And there's a final point to make. If the Bank of England really cannot work out that this inflation is something that they can't solve, they shouldn't be in their jobs.

That's my opinion. What do you think? There's a poll down below.

Poll

[poll id="344"]